

Private Equity

Volume 2: Venture Capital

The law in key jurisdictions worldwide

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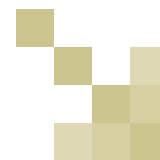
Ireland

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MARKET

1. Please describe briefly the venture capital market in your jurisdiction, in particular:

- How it is distinguished from private equity.
- The sources from which early stage companies obtain funding.
- The types of companies that attract venture capital investment.
- Market trends (for example, levels of investment, the type of companies invested in and where those companies are located).

Venture capital and private equity

Venture capital and private equity are concerned with the investment of money in unquoted companies.

While venture capital is effectively a form of private equity, the term typically refers to investments in start-up or developing companies to fund research and development, expansion or growth.

Private equity typically refers to investment in mature cash-generating businesses to finance acquisitions, restructurings, consolidations or buyouts.

Sources of funding

The Irish market includes:

- Independent Irish, UK, North American and European venture capital firms and private equity houses.
- Private equity funds operated by Irish financial institutions.
- Irish government agencies.
- Corporate funds.
- Private high net-worth individuals.

Types of company

Historically, most venture capital investment has been in companies operating in the technology sector, particularly software and communications companies. However, in recent years, other

types of business, including life sciences, manufacturing, renewable energy and food companies, have also attracted venture capital investment.

Market trends

According to the Irish Venture Capital Association VenturePulse survey (IVCA Survey) published in October 2008, EUR173.4 million (about US\$220 million) was raised by Irish companies to the end of the third quarter in 2008 from both local and overseas investors. This amount is up on the EUR141.5 million (about US\$180 million) raised in the same period in 2007 and the EUR162.7 million (about US\$217 million) raised in the same period in 2006.

The IVCA Survey further shows that the number of companies that raised funds to the end of the third quarter in 2008 was 64 compared to 73 in the same period in 2007 and 31 for the same period in 2006. Therefore, by the end of the third quarter 2008, the average amount invested per deal in 2008 was slightly up on 2007 but down on 2006.

According to the IVCA Survey, communications (20% of total), telecoms (19%), drug delivery and medical equipment (19%), and technology (19%) companies attracted the most investment to the end of the third quarter in 2008. However, in line with US and European trends, Ireland is currently seeing a great deal of interest in renewable energy technologies (cleantech), and a marked increase in investment in this sector is expected in the future.

2. What tax incentive schemes exist to encourage investment in venture capital companies? At whom are the schemes directed? What conditions must be met?

Business Expansion Scheme (BES)

The BES is a tax incentive scheme to encourage individuals subject to Irish income tax to invest in SMEs which meet certain qualifying criteria. In summary, the BES operates in the following way:

- Individuals can obtain relief from Irish income tax on investments in qualifying companies of up to EUR150,000 (about US\$190,466) per annum in each tax year to 31 December 2013. Relief is available at the individual investor's highest rate of income tax. An individual investor who cannot obtain relief on all his investments in any particular tax year can carry forward the unrelieved amount to the following tax year up to 31 December 2013.

- Investments must be in qualifying companies. Qualifying companies are SMEs engaged in certain activities including the manufacturing of goods, internationally traded services, and research and development. Qualifying companies must be resident in Ireland (or resident in the European Economic Area with an establishment carrying on a qualifying activity in Ireland (in the case of small sized companies) or in certain areas of Ireland (in the case of medium sized companies)) and must, in general, be unquoted.
- Investments must be for ordinary shares in the capital of the investee company and not shares that carry any preferred rights. The minimum qualifying investment by an individual is EUR250 (about US\$317). The maximum qualifying investment by all investors in any one company or group of companies is EUR2 million (about US\$2.5 million), subject to a maximum of EUR1.5 million (about US\$1.9 million) being invested in any 12-month period. All shares must be issued paid-up in full and an individual must hold the shares for a period of five years. If an individual sells some, or all, of the shares within the five-year period, he may lose part, or all, of the relief.

Seed Capital Scheme

The Seed Capital Scheme is a tax incentive scheme to encourage individuals subject to Irish income tax to invest in SMEs which meet certain qualifying criteria.

In particular, the Seed Capital Scheme is designed to encourage employees, unemployed persons, or persons who were made recently redundant, and who are interested in starting their own businesses, to do so. In summary, the Seed Capital Scheme works as follows:

- Individuals can obtain a refund of Irish income tax already paid on investments in qualifying companies of up to EUR100,000 (about US\$126,977) per annum in each of the previous six tax years. Refunds are given in the year in which an investment is made. Refunds are available for each tax year up to 31 December 2013.
- Investments must be in qualifying companies. Qualifying companies are companies which qualify for BES relief (see above, *Business Expansion Scheme (BES)*).
- Investments must be for ordinary shares in the capital of the investee company and not shares that carry any preferred rights. All shares must be issued paid-up in full and an individual must hold the shares for five years. An individual must enter into a full-time employment contract for at least one year with the investee company as an employee or a director starting either within the tax year in which the investment is made or, if later, within six months of the date on which the investment is made. If an individual sells some, or all, of the shares within the five-year period, he may lose part, or all, of the relief.

Qualifying Patent Exemption

The Qualifying Patent Exemption is a tax exemption to encourage research and development activity in Ireland. Where income is derived by a company from a qualifying patent, it is exempt from Irish corporation tax, subject to certain conditions and an annual limitation of EUR5 million (about US\$6.3 million). The

exemption also extends to Irish income tax on dividends received by individuals from a tax exempt patent company.

Relief for investment in renewable energy generation

Companies are entitled to relief for investment in certain renewable energy projects. Eligibility for the relief ends on 31 December 2011.

The relief takes the form of a deduction from the profits of a company in respect of an investment in new shares in an investee company carrying out a qualifying renewable energy project. Qualifying projects for this purpose are those in the solar, wind, hydro and biomass technology categories, which have been individually approved by the Minister for Minister for Communications, Marine and Natural Resources through the issue of a certificate.

The maximum amount of relief is the lesser of:

- 50% of all capital expenditure, excluding expenditure on land and net of grants on a single project.
- EUR9.525 million (about US\$12.1 million).

Investment by any one company or group of companies in more than one energy renewal project is capped at EUR12.7 million (about US\$16.9 million) per annum.

Relief will be withdrawn in cases where shares are held for less than five years.

3. From what sources do venture capital funds typically receive funding?

Irish venture capital funds typically receive funds from a variety of:

- Financial institutions.
- Pension funds.
- Government agencies.
- Corporate investors.
- Private high net-worth individuals.

4. Can the structure of the venture capital fund impact on how investments are made?

Most Irish venture capital funds are established as unregulated limited partnerships under the Limited Partnership Act 1907. Structuring venture capital funds as unregulated limited partnerships provides maximum flexibility to promoters and investors with regard to the:

- Marketing of the fund.
- Making of investments.
- Ongoing governance.
- Dissolution and return of capital on liquidation of the fund.

It is also possible to structure venture capital funds as investment funds or investment limited partnerships regulated by the Irish Financial Services Regulatory Authority (Financial Regulator); however, this is rarely done. Regulated investment funds and regulated investment limited partnerships are subject to certain restrictions, including investment and borrowing limits (although in the case of funds targeted at professional investors, institutions and high net-worth individuals, derogations are available from many of the restrictions). Additionally, regulated funds are subject to certain requirements as to the suitability of the promoters and managers of those funds and must appoint independent custodians and administrators.

In addition, the manner in which a venture capital fund structured as an unregulated limited partnership can make investments is prescribed by the terms of the limited partnership agreement under which it is established. The terms of that agreement, including, for example, provisions dealing with investment term and policy are of material importance to what type of, and how, investments are made.

5. Do venture capital funds typically invest with other funds?

UK, North American and European venture capital funds often seek local venture capital funds to co-invest with them when making investments in Irish companies. Irish venture capital funds frequently invest with Irish government agencies such as Enterprise Ireland and with private individuals.

FUND FORMATION AND REGULATION

6. What legal structure(s) are most commonly used as vehicles for venture capital funds in your jurisdiction?

Most Irish venture capital funds are established as unregulated limited partnerships (see Question 4). The promoters (that is, the venture capitalists) control the general partner and, either through the general partner or a separate management company, manage the investment activities of the fund.

Usually, the general partner contributes a small proportion of the fund's capital (1%) and investors, through becoming limited partners, commit the balance. The promoters are generally compensated in two ways:

- Firstly, by an annual management fee paid to the general partner/manager.
- Secondly, from sharing in a percentage of any capital gains generated from the sale of investments in portfolio investee companies in which the fund has invested (carried interest).

A limited partnership does not have a separate legal personality and is regarded as tax transparent by the Irish Revenue authorities.

It is also possible to structure venture capital funds as investment funds or investment limited partnerships regulated by the Financial Regulator. However, to ensure flexibility in their structures (including in terms of marketing a fund, making investments, ongoing governance, dissolution and return of capital), most venture capital funds are structured as unregulated limited partnerships (see Question 4).

7. Do a venture capital fund's promoter, manager and principals require licences?

Typically, where the fund is structured as an unregulated limited partnership, no licences are required unless the fund is providing certain investment services.

If the fund is structured as a regulated investment fund or a regulated investment limited partnership, approvals and authorisations must be obtained from the Financial Regulator.

8. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions? Include, in the answer, any restrictions on how a venture capital fund can be marketed or advertised (for example, under private placement or prospectus rules).

It is possible to set up regulated investment funds engaging in venture capital investments; these are structured as unit trusts or investment companies. It is also possible to set up regulated investment limited partnerships.

The consequences of regulation are that a fund is subject to:

- The Financial Regulator's investment and borrowing limits, except in the case of funds targeted at professional investors, institutions and high net-worth individuals, where derogations are available from many of the restrictions (see Question 4).
- Requirements as to the suitability of the promoter and manager of the fund and the need to appoint an independent custodian and administrator (see Questions 4 and 7).

All regulated funds must be marketed in accordance with the Financial Regulator's notices on the marketing of funds.

Unregulated limited partnerships can potentially be constituted as an unauthorised unit trust for the purposes of the Unit Trusts Act 1990 and there are prohibitions on marketing unit trust schemes to the public. However, an unregulated venture capital fund established as a limited partnership can be structured so as not to fall subject to these prohibitions.

9. How is the relationship between investor and fund governed? What protections do investors typically seek?

The manner in which an unregulated fund can make investments is prescribed by the terms of the limited partnership agreement under which it is established. The promoters control the general partner and, either through the general partner or a separate management company, manage the investment activities of the fund. The general partner has unlimited liability to third parties. The principal protection for investors is the benefit of limited liability, which they obtain by investing as limited partners; the liability of a limited partner cannot exceed the amount of his, or its, capital commitment.

Other typical protections which investors may seek include:

- Restrictions on the activities of the general partner, promoters and/or managers from managing or sourcing transactions for other funds.
- Key-man event protection where, if certain key persons resign, or otherwise cease employment with the general partner or manager, and are not replaced to the satisfaction of the investors, certain investor rights apply. These rights may include the ability to block the fund from making further investments and/or to compel the winding-up of the fund.

If investors are investing in regulated funds, protections are afforded under the regulatory framework supervised by the Financial Regulator.

10. What are the most common investment objectives of venture capital funds (for example, what is the average life of a fund, what return will a fund be looking for on its investments and what is the time frame within which a fund would seek to exit its investment)?

Most venture capital funds have a term of ten years, with the possibility of extending that term to allow a greater period for liquidating the fund's interests in all portfolio investee companies.

Typically, funds have an initial investment period of three to five years to source and invest in new companies. Following this initial investment period, the terms of the fund generally restrict its purpose to managing and making follow-on investments in existing portfolio investee companies. Generally, venture capital funds look for returns of between 30% and 40% per annum by way of capital gain. Venture capital funds seek a superior rate of return to private equity funds because:

- Investments carry a high level of risk and exposure.
- Investments are locked in for a long period of time.
- There are few opportunities to receive interim payments on investments by way of dividends or otherwise.

A venture capital fund typically expects an exit opportunity from a portfolio investee company within four to six years of its initial investment.

INVESTMENTS

11. What form of investment do venture capital funds take? (For example, equity, debt or a combination.)

Typically, venture capital funds invest by subscribing for equity of a class carrying preferred rights to that of the holders of the ordinary equity in the capital of the company. The preferred rights generally include the following:

- The right to be repaid the amount, or a guaranteed a multiple of the amount, of its investment on an exit or on the liquida-

tion of the portfolio investee company in priority to the holders of the ordinary equity (liquidation preference rights).

- Veto rights in relation to certain corporate and business actions by, or relating to, the portfolio investee company.
- Anti-dilution protection.

The preferred shares are also generally convertible into ordinary shares at the discretion of an investor and automatically convert on the occurrence of certain agreed exit events, for example, an initial public offering at a pre-agreed minimum valuation.

In some circumstances, such as to provide necessary bridging finance, venture capital funds may lend money, either by way of a straight loan or convertible security, to investee companies. Funds operated by financial institutions sometimes invest by a combination of equity and mezzanine debt.

12. How do venture capital funds value an investee company?

Venture capital funds value investee companies using a variety of methods which differ depending on an investee company's stage of development. Factors that are considered when evaluating early stage investee companies are:

- The founders' investment in the form of cash or work.
- Opportunity cost.
- Intellectual value.

Previous demonstrable success in a venture-backed company may increase the founders' negotiating position. Factors considered when evaluating expansion or growth stage companies include comparable company multiples of sales, while later stage companies are valued based on comparable earnings multiples.

In all cases, valuation correlates with potential growth and earnings.

13. What investigations will venture capital funds carry out on potential investee companies?

Venture capital funds typically carry out business, accounting, legal and tax due diligence on an investee company to evaluate investment risk. The risk typically falls into three principal categories:

- Management risk.
- Product risk.
- Market risk.

As part of this risk evaluation process, venture capital funds pay keen attention to the business plan, in particular the feasibility of delivering the projected growth potential, the amount of projected funds required to do so and the capability of management.

14. What are the principal legal documents used in a venture capital transaction?

The following principal legal documents are used in a venture capital transaction:

- A subscription agreement under which the venture capital investor agrees to subscribe for preferred shares. This agreement generally contains representations and warranties regarding the investee company given for the benefit of the venture capital investor and non-compete covenants from founders and management shareholders.
- A shareholders' agreement under which the business of the investee company and the relationship of the venture capital investor and other shareholders are regulated. This agreement generally contains a number of contractual rights for the benefit of the venture capital investor, including:
 - veto rights in relation to certain corporate and business actions by, or relating to, the investee company;
 - information rights; and
 - the right to board representation.
- The articles of association of the investee company, which contain the rights attaching to the various classes of shares in the capital of the company, including the venture capital investor's preferred equity. These include:
 - voting rights;
 - dividend rights;
 - liquidation preference rights;
 - anti-dilution rights;
 - drag-along rights; and
 - tag-along rights.

15. What form of contractual protection does an investor receive on its investment in a company?

A venture capital investor typically receives a number of contractual protections on its investment, including the following (see also Question 14):

- Comprehensive commercial representations and warranties from the investee company and founders/management shareholders.
- Non-compete covenants from founders/management shareholders.
- Step-in rights in the event that the business of the investee company is being conducted in a fraudulent or illegal manner or materially in breach of the agreed covenants in the shareholders' agreement.

- Liquidation preferences and anti-dilution protections on its preferred equity.

16. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

Typically, venture capital funds invest by subscribing for equity of a class carrying preferred rights to that of the holders of the ordinary equity in the capital of the company.

17. What rights does a fund have in its capacity as a holder of preferred shares (for example, what rights to capital and/or to interest)?

A venture capital investor holding preferred shares typically has the following rights:

- The right to be repaid the amount, or a guaranteed multiple of the amount, of its investment on the occurrence of an exit or on the liquidation of the portfolio investee company in priority to the holders of the ordinary equity (liquidation preference rights).
- Veto rights in relation to certain corporate and business actions by, or relating to, the portfolio investee company.
- Anti-dilution protection, drag-along rights and tag-along rights.

The preferred shares are also generally convertible into ordinary equity at the discretion of an investor and will automatically convert on the occurrence of certain agreed exit events, such as an initial public offering at pre-agreed minimum valuation.

18. What rights are commonly used to give a fund a level of management control over the activities of an investee company (for example, board representation, certain acts of the company subject to investor consent)?

A venture capital investor generally can appoint one or more directors to the board of an investee company, and remove and replace any persons appointed. A venture capital investor may also have the right to appoint a non-voting observer to attend board meetings. Typically, a venture capital investor appointee must be part of the quorum for a meeting of the board of directors.

19. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation?

Except for transfers to permitted transferees (such as close family members or controlled companies), founders and management shareholders have very limited scope to transfer their shares for if a venture capital investor holds preferred shares or until an exit is achieved. The venture capital investors have a broad scope to transfer their shares.

20. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company (for example, drag-along and tag-along rights)?

Venture capital investors typically have both drag-along and tag-along protection.

Under drag-along provisions, venture capital investors holding a specific percentage of the preferred shares, or venture capital investors and holders of ordinary shares holding a specific percentage of the preferred shares and ordinary shares, taken as a single class, who wish to accept an offer for the all the shares of a portfolio investee company, can typically compel any shareholders who do not wish to accept such an offer to join in the sale.

Under the tag-along provisions, venture capital investors can typically block the sale of any shares by any other shareholder to a third party unless that third party also agrees to buy equivalent portions of their shares at the same price.

21. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

Investors typically require pre-emption rights in relation to any further issues of shares by an investee company.

22. What consents are required to approve the investment documentation?

The board of directors of the investee company must approve the investment documentation. Additionally, shareholder consents are required if the terms of the investment require the termination of existing shareholders' agreements or the adoption of new articles of association.

23. Who covers the costs of the venture capital funds?

The transaction costs incurred by the venture capital investors are generally covered by the investee company.

FOUNDER AND EMPLOYEE INCENTIVISATION

24. In what ways are founders and employees incentivised (for example, through the grant of shares, options or otherwise)? What are the resulting tax considerations?

Founders and employees shareholders are typically incentivised through:

- Bonus schemes, under which the company pays cash bonuses.
- Share option schemes, under which the relevant portfolio investee company grants options to subscribe for shares in

the capital of the company; these options typically have a vesting period before they can be exercised and are subject to good leaver/bad leaver provisions.

- Equity ratchets, under which founders and management may be given increased share rights, or the venture capital investor's share rights are decreased by reference to exit valuations achieved.

Bonus payments for Irish resident individuals are subject to income tax at the prevailing rate (the highest rate is currently 41%).

If the options are not capable of exercise after seven years from their date of grant, the grant of a share option has no tax consequences for Irish resident holders. On exercise of a share option, an Irish resident holder must pay income tax on the difference between the:

- Exercise price for the option.
- Market value of the relevant shares on the date of exercise of the option (if greater).

A further charge to capital gains tax arises on a subsequent disposal of the shares. An Irish resident holder must pay capital gains tax (currently 20%) on the difference between the market value of the relevant shares on the date of exercise of the option and the sale price of the shares (if higher).

Until a recent change in the tax laws, deferred share/restricted stock schemes, which attracted capital gains tax, but not income tax treatment, were a popular means of incentivising founders and employees. These schemes operated by issuing convertible securities of little, or no, value which could become convertible into valuable equity on the occurrence of certain events. However employment-related convertible securities issued under such schemes after 31 January 2008 will now be subject to income tax rather than capital gains tax. Securities already issued before that date are not affected.

25. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture (for example, good leaver/bad leaver provisions and restrictive covenants)?

Good leaver/bad leaver protections which apply to the equity and/or options held by founders are common. Restrictive covenants apply to founders and shareholder managers in almost all transactions.

EXITS

26. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

Exits from an unsuccessful portfolio investee company are generally determined by the financial circumstances of the company

and the prevailing economic conditions affecting the market in which it operates or the financial markets generally. The most common forms of exit are:

- Sale of the company to another investor or management.
- Liquidation of the company.

A sale of the portfolio investee company allows the venture capital investor to recover some of its investment and to avoid involvement in the liquidation procedure. In a liquidation situation, the directors of an insolvent company (including investor appointees) are exposed to potential liability if the company is considered, under Irish law, to have traded recklessly or fraudulently while insolvent and creditors suffer loss. In an insolvency situation, these directors must carefully consider their legal obligations to creditors.

27. What forms of exit are typically used to realise a venture capital fund's investment in a successful company (for example, trade sale, initial public offering and secondary buyout)? What are the relative advantages and disadvantages of each?

The following forms of exit are typically used:

- Trade sales.
- Sales to other venture capital or private equity funds.
- IPOs.

Trade sales and sales to other private equity funds have the advantage over IPOs of generally being more straightforward to execute and they allow the selling venture capital fund to exit 100%. IPOs potentially give venture capital funds the opportunity to achieve higher exit multiples. However, they typically involve greater execution risk, particularly as public markets can be volatile and a venture capital fund may not be able to sell 100% of its holding at the time of the IPO.

28. How can this exit strategy be built into the investment?

In many cases, venture capital investors seek a contractual entitlement, after a certain period of time (typically, four to six years) to instigate, or compel, a process that will lead to a sale or IPO of the portfolio investee company.

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